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Person To Contact:
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Date:
July 07, 2009

LEGEND:

County A =

County B =

State =

State ISO =

State PUC

a

Change

Dear :

This is in response to your request for a ruling to eliminate the Annual Net Importer Test (described below) as a prerequisite to satisfy the Character Requirement (described below) in order for the Utility to qualify its system as facilities for local furnishing of electric energy within the meaning of §142(a)(8) of the Internal Revenue Code (the "Code").

In the event that the request is denied, you have requested an alternative ruling that the Annual Net Importer Test disregard (1) outbound flows caused by wheeling of electricity generated by resources not controlled by or for the benefit of Utility, and (2) outbound flows caused by wholesale sales of excess electricity from Utility's Generating Units (defined below) if such sales are required pursuant to Federal or State regulations, rules, orders, decisions or mandatory protocols.

FACTS AND REPRESENTATIONS:

Utility provides retail electric delivery service and retail electric supply service within most of County A and a contiguous portion of County B (the “Service Area”). Utility is authorized to provide retail electric services solely to customers within the Service Area pursuant to the State PUC’s certificate of public convenience and necessity. Utility is the sole system to provide bundled electric service on a priority basis to customers in the Service Area. Utility wholly owns and operates (or by long-term power purchase agreements, controls) an integrated system of electric generation, transmission, and distribution facilities that are directly connected to each other and that comprise most of Utility’s facilities used to provide electric service throughout the Service Area (the “Local System”).

The IRS has issued previous rulings regarding Utility and the Local System. In determining whether the Local System constitutes facilities for the local furnishing of electric energy, the IRS has required Utility to demonstrate that the Local System has not been designed differently, sized larger, built sooner, or constructed in a more costly fashion than is reasonably required solely for the purpose of serving the Service Area, and none of such facilities would have been planned or constructed for any reason other than to provide electric service to the retail customers served by Utility within the Service Area (taken all together, the “Character Requirement”). The IRS adopted the standard that Utility be a net importer of electric energy measured on an annual basis (the “Annual Net Importer Test”) to substantiate that the Local System meets the Character Requirement.

The Local System continues to satisfy the Character Requirement. Absent an order from FERC under §§ 211 or 213 of the Federal Power Act (per §142(f)(2)(A) of the Code), Utility has not constructed or acquired any component of the Local System, larger, sooner, more costly, or of any different design than was or will be reasonably considered necessary for the provision of electric service to Utility’s retail customers within the Service Area (the “Local Retail Customers”).

Utility’s transmission facilities do not have aggregate transmission capability in excess of that needed to meet the needs of the Local Retail Customers and reliability requirements (including the reserve requirements) imposed by Federal and State regulators. Nevertheless, fundamental changes in the electric utility industry require Utility to wheel electricity from generating sources not controlled by or used for the benefit of Utility for ultimate delivery to consumers who are not Local Retail Customers. Utility’s transmission resources are held on a priority basis to serve the Local Retail Customers. Use of the transmission facilities in wheeling transactions reflects the use of transmission capacity that is not then needed to service those Local Retail Customers and is pursuant to open access orders or mandatory protocols of the Federal Energy Regulatory Commission (“FERC”), the State PUC and/or the State ISO.

Mandated wheeling could cause Utility's outbound flows of electricity to exceed inbound flows needed for Local Retail Customers.

Utility's local and remote generating units, including all generation controlled by or for the benefit of Utility ("Utility's Generating Units"), do not have aggregate generating capability in excess of that required by the State PUC and the FERC-approved State ISO tariff to meet the needs of the Local Retail Customers (including the reserve requirements). However, fundamental industry changes have also affected Utility's Generating Units. The State PUC and the State ISO, in order to ensure a supply of energy throughout the State, require Utility to comply with least-cost, best-fit dispatch orders or mandatory protocols. These orders or protocols may require Utility's Generating Units to run even though Utility has sufficient energy to supply the Service Area. The State ISO requires Utility to acquire generation equal to its peak period load plus a reliability reserve of an additional a%. Some of Utility's Generating Units cannot reduce generation from these required levels in order to accommodate off-peak periods without, at times, resulting in excess energy. Pursuant to orders or mandatory protocols of the State PUC and/or the State ISO, Utility is required to sell excess energy to wholesale customers that may be outside of the Service Area. Utility's Generating Units are held on a priority basis to serve the Local Retail Customers, so wholesale sales, which cause Utility to incur outbound flows of generated power, reflect the use of generating capacity that is not then needed to service actual loads of the Local Retail Customers and are pursuant to least-cost, best-fit dispatch orders or mandatory protocols of the State PUC and/or the State ISO.

The State ISO implemented the Change subsequent to the filing of the ruling request. Under the Change, Utility is no longer required to match its Generating Units to the Local Retail Customer demand. It is now permitted to bid all its generation supply resources into the State ISO spot market and to bid all its forecast Local Retail Customer demand into the State ISO spot market. To the extent Utility's Generating Units are not needed on a priority basis at a particular moment in time to provide reliable service to the Local Retail Customers, the State PUC's least-cost, best-fit principles are applied to ensure that Utility's Generating Units are available for spot sales through the State ISO or otherwise on the bilateral wholesale market. These principles also are applied to ensure that Utility purchase electric energy through the State ISO or otherwise on the bilateral spot market, rather than taking electric energy from Utility's Generating Units, if doing so will result in lower overall costs to the Local Retail Customers.

LAW AND ANALYSIS

Section 142(a)(8) provides that for purposes of Subtitle A, Chapter 1B, Part IV of the Code, the term "exempt facility bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used to provide facilities for the local furnishing of electric energy or gas.

Section 142(f)(1) provides that the local furnishing of electric energy or gas shall only include furnishing solely within the area consisting of a city and one contiguous county, or two contiguous counties.

Section 142(f)(2) provides that a facility shall not be treated as failing to meet the local furnishing requirement of § 142(a)(8) by reason of electricity transmitted pursuant to an order of the Federal Energy Regulatory Commission under §§ 211 or 213 of the Federal Power Act (as in effect on the date of the enactment of § 142(f)(2)) if the portion of the cost of the facility financed with tax-exempt bonds is not greater than the portion of the cost of the facility which is allocable to the local furnishing of electric energy (determined without regard to § 142(f)(2)).

Section 142(f)(2) was enacted as part of the Energy Policy Act of 1992, Pub. L. No. 102-485. The legislative history states, "The committee believes further that, in applying the IRS ruling position that a local furnishing utility that is interconnected with other utilities (other than for emergency transfers of electricity) must be a net importer of electricity, the determination of whether the utility is a net importer should be made without regard to electricity generated by another party that is wheeled by the utility to a point outside its service area pursuant to a FERC order authorized under the bill." H. R. Rept. No. 474, 102d Cong. 2d Sess., at 24 (1992).

Section 1.103-8(f)(2)(iii) of the Income Tax Regulations provides that the term "facilities for the local furnishing of electric energy or gas" means property which-

(a) Is either property of a character subject to the allowance for depreciation provided in section 167 or land,

(b) Is used to produce, collect, generate, transmit, store, distribute, or convey electric energy or gas,

(c) Is used in the trade or business of furnishing electric energy or gas, and

(d) Is a part of a system providing service to the general populace of one or more communities or municipalities, but in no event more than 2 contiguous counties (or a political equivalent) whether or not such counties are located in one state. A facility for the generation of electric energy otherwise qualifying under this subdivision will not be disqualified because it is connected to a system for interconnection with other public utility systems for the emergency transfer of electric energy.

Due to industry restructuring, the State PUC and the State ISO require Utility to maintain a reliability reserve of a% of Utility's Generating Units at peak periods. The

requirement to maintain this reserve, coupled with Utility's inability to adjust some generation down for off-peak periods, can result in Utility's Generating Units producing electricity beyond that required for the Local Retail Customers. Additionally, the State PUC's and the State ISO's least-cost, best fit policy requires Utility to run its Generating Units, at times, without regard to the needs of the Local Retail Customers and to sell this excess generation in wholesale sales that may be outside of the Service Area. Although § 142(f)(2) only applies to wheeling transactions mandated by FERC, we believe that both Federal and State regulatory mandated sales of excess electricity outside the Service Area should be excepted from the Annual Net Importer Test. In both situations, Utility has no control over the transactions and both occur in the course of Utility's business as a local furnisher and both result in outbound flows of electricity. Cf. § 1.141-7(g)(4)(i)(A) which excepts mandated wheeling due to both Federal and State regulatory authority from the deliberate action rules.

We disagree that the Annual Net Importer Test should be eliminated as a means of demonstrating whether the Local System are facilities for local furnishing under § 142(a)(8). Instead, we conclude that modifying the Annual Net Importer Test to disregard (1) outbound flows caused by wheeling of electricity generated by resources not controlled by or for the benefit of Utility, and (2) outbound flows caused by wholesale sales of excess electricity from Utility's Generating Units if required pursuant to Federal or State regulations, rules, orders, decisions or mandatory protocols (the "Amended Annual Net Importer Test"), accurately addresses the constraints imposed on Utility due to industry restructuring that are beyond Utility's control and required in the course of Utility's business to serve the Local Retail Customers within the Service Area. However, wholesale sales of excess power may be exempted from outbound flows only if for each calendar year the total amount of electric energy supplied by Utility to the Local Retail Customers equals or exceeds the total amount of electric energy generated by Utility's Generating Units less (i) line losses, (ii) a% reserve, (iii) the State PUC and/or the State ISO least-cost, best-fit orders, and (iv) excess due to Utility's inability to reduce generation from peak levels during off-peak periods. The Amended Annual Net Importer Test as so applied constitutes the revised standard to substantiate that the Local System meets the Character Requirement.

In addition, even if the Local System meets the definition of facilities for local furnishing of electric energy, Utility must comply with the requirements of § 142(f)(2)(A) that the portion of the cost of the Local System financed with tax-exempt bonds may not exceed the portion of the cost of the Local System allocable to the local furnishing of electric energy. In determining the portion of use of the Local System as defined in § 1.103-8(f)(2)(iii) that is allocable to the local furnishing of electric energy, Utility must aggregate the components of the Local System described in § 1.103-8(f)(2)(iii)(b).

CONCLUSION:

Based solely on the representations and facts submitted by Utility, we conclude that for purposes of determining that the Local System are facilities for local furnishing, Utility may demonstrate compliance with the Character Requirement based on the Amended Annual Net Importer Test. However, for purposes of complying with § 142(f)(2)(A), to the extent that the portion of the cost of the Local System financed with tax-exempt bonds is greater than the portion of the cost of the Local System allocable to the local furnishing of electric energy, Utility must redeem tax-exempt bonds.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Timothy L. Jones
Sr. Counsel, Branch 5
Associate Chief Counsel (Financial Institutions
and Products)